No. 15,181

In the

United States Court of Appeals

For the Ninth Circuit

JOHN P. DALEY, MINERVA B. DALEY, MORRIS DALEY, ZELMA B. DALEY, WILLIAM RADTKE, CLARA RADTKE and HOMER BOSSE, Trustee of the Estates of Morris K. Daley, Alice M. Daley, Susan R. Daley, James D. Daley, Kathryn F. Daley and Peter D. Daley,

Appellants,

vs.

UNITED STATES OF AMERICA,

Appellee.

Appellants' Closing Brief

See Supplemental on back cover

ERIC SUTCLIFFE

WILLIAM D. McKEE

ORRICK, DAHLQUIST, HERRINGTON & SUTCLIFFE

405 Montgomery Street
San Francisco 4, California

Attorneys for Appellants

PARKER PRINTING COMPANY, 180 FIRST STREET, SAN FRANCISCO 5

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I.

INTRODUCTION

The taxpayers made at least one extremely serious error in their 1942 Income tax returns. It has been argued by the taxpayers, found by the District Court, and at last conceded by the United States (Br. 11, 12, 13, 26, 29, 31), that approximately $473,000.00 was erroneously included in income for that year. The question presented is whether the taxpayers are going to be deprived of a refund of the income taxes overpaid as a result of their erroneous returns.

II.

ARGUMENT

1. Appellants Used the Completed Contract Method.

The Brief for the Appellee states that the question of whether taxpayers adopted the completed contract method for reporting income from the Delta contract "is purely factual and the findings of the District Court in that respect should not be disturbed unless clearly erroneous" (Br. 15).

But the Court below *did not treat* this issue as factual. The Court's determination of this issue is in paragraph III of its "Conclusions of Law", and not in its "Findings of Fact". It is clear from a reading of the Court's opinion and of the entire record that the Court below found, *as a matter of law,* that if a taxpayer reports income from a contract before it is completed, he has not elected the completed contract method. In this the District Court was in error. *E. E. Black Ltd. v. Alsup,* 211 F.2d 879 (9th Cir., 1954) and the other cases cited in our Opening Brief clearly demonstrate that the reporting of income when the contract is fully completed is only one of the aspects of the completed contract method, and that the fundamental and distinguishing feature of that method is reporting all income and deductions from the contract in the same year.[1]

To be sure, the District Court should have treated the issue as a factual issue, and should have determined the issue from the evidence of the manner in which the books are kept. Int. Rev. Code § 41 ("The net income shall be computed in accordance with the method of accounting regularly employed in *keeping the books* of such taxpayer.")

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1. In addition to the cases cited on page 17 of Appellants' Opening Brief, see *National Contracting Co. v. Comm'r,* 37 B.T.A. 689, 702, aff'd (8th Cir.), 105 F.2d 488, and *In re Harrington,* 1 F.2d 749. Note also that the Brief for the Appellee cites no cases and makes no argument to the effect that this is not the fundamental feature of the completed contract method.

However, despite the extensive evidence which was submitted with respect to the manner of keeping the books, *not one word is found,* either in the Court's opinion or in its Findings of Fact, relative thereto. In this, it is submitted, the Court clearly erred. And if the issue had been treated as a factual issue, a finding that the accrual method of reporting income was adopted rather than the completed contract method, would have been clearly erroneous.

The most important aspect of the accounts in determining the method of accounting adopted is the "principal and dominant purpose and plan" of the accounts. *Niles Bement Pond Co. v. U.S.,* 281 U.S. 357, 360, cited by Appellee (Br. 15). Thus, in that case, the Supreme Court stated: "The Court of Claims found that *the books of the petitioner* were kept on the accrual basis; that, while there were some exceptions * * * 'the principal and dominant purpose and plan of its accounts were to show income upon an accrual basis as the general and controlling character of the account' ". (Italics added.) Just as in the *Niles Bement Pond* case the "principal and dominant purpose and plan" of the taxpayers' accounts were to show income upon an accrual basis, so, in this case, the principal and dominant purpose and plan of the accounts and of the tax return were to show the profit from a completed contract. The clear and unequivocal testimony was that the full contract price was entered on the books when the contract was entered into, and not at any later time when the right to partial payments under the contract became fixed, and thus accrued. (Tr. 223-225). Does this sound as though the "principal and dominant purpose and plan of its accounts were to show income upon *an accrual basis"?* Obviously not. This practice is appropriate only if the taxpayer waits to close out the books of account until all costs are incurred and entered on the books of account and the contract is completed. The evidence as to the manner in which the accounts were closed out was also consistent *only* with the completed contract method of accounting (Op. Br. 11).

Appellee has pointed out that since the primary recording of financial data may be done on an accrual basis, but profit and loss may still be determined on a completed contract basis, it is helpful to look to "the facts surrounding the point of election" to determine whether the completed contract method was elected (Br. 18). Appellee's point would be well taken if the manner in which the taxpayers' books were kept were consistent with anything other than the completed contract method of reporting income. Since the statute itself requires that the tax returns be prepared "in accordance with the method of accounting regularly employed in keeping the books", the surrounding circumstances can have only secondary significance.[2]

The fact "surrounding" the election which Appellee finds of greatest significance is that the Appellants knew that the contract was not completed before the end of 1942. This, it is urged, is conclusive that the completed contract method was not utilized. But on the same basis of reasoning Appellants can argue that the fact that $472,722.15 which *had not* accrued was put into the 1942 return is conclusive evidence that the accrual method was not adopted. Moreover, Appellants submit that if all of the surrounding facts are examined, and not only the isolated fact cited by Appellee, those facts provide strong support that the method of accounting used by Appellants was the completed contract method. Mr. Daley testified as to the reason why the Delta contract profit was estimated as of the end of 1942 even though he knew it was only 99% completed at that time. It was because the renegotiation officer wanted the profit from the contract estimated so that it could be renegotiated with other contracts completed in 1942. Mr

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2. The following cases hold that if the books are kept on the completed contract method, the taxpayer is not entitled to elect any other method: *H. S. Bent v. Comm'r* (9th Cir., 1932), 56 F.2d 99; *Alfred H. Badgley v. Comm'r* (1931), 21 B.T.A. 1055; *Russell G. Finn, et al. v. Comm'r* (1931), 22 B.T.A. 799; *R. G. Bent Co. v. Comm'r* (1932), 26 B.T.A. 1369.

Daley thought that if he closed out the books on the contract for renegotiation purposes he had to do the same thing for tax purposes (Tr. 186-189).

Appellee has made a number of cynical remarks concerning this testimony of Mr. Daley's. It is stated that Mr. Daley's explanation lacked "plausibility", and that the assertion that the renegotiation officer wanted the profit from the contract estimated so that he could renegotiate the contract and "get off and go to war" appears "far-fetched" (Br. 22). Whether Mr. Daley's testimony lacked plausibility and was far-fetched is perhaps best left to this Court to be judged by the war-time recollections of its members. However, if Appellee means to question Mr. Daley's good faith, it is suggested that his testimony with respect to this matter be read. His testimony appears on pages 186-189 of the Transcript of Record, and even in cold print its sincerity is palpable. In addition, of course, there has not been the faintest hint as to any other reason why the results from the Delta contract would have been estimated at the end of 1942 instead of waiting until it was completed in accordance with the practice which had consistently been followed by the taxpayers since 1921 and thereafter until the time of the trial (Tr. 189-190).

These surrounding facts not only support Appellants' contention that the 1942 income tax return was prepared upon what was basically the completed contract method, they also show that it was *not* the intention to report income on the accrual method. The accrual method imports that you report income when the right to the income has matured. *Spring City Foundry Company v. Comm'r* (1934), 292 U.S. 182, 54 S. Ct. 644. Mr. Daley testified that he knew the income from the contract reported in the 1942 return had *not* matured and the profit shown on the return was only the "anticipated" profit (Tr. 146, 166, 167, 172). Mr. Gillard, representing the Appellee, made the same point at the trial of this

case when he agreed that the 1942 return reflected anticipated rather than matured revenues and costs. He said:

> "That joint venture filed a return on the accrual basis at the end of 1942 accruing the total *anticipated* revenue from the contract, accruing the total *anticipated* costs from the contract, computing the net profit, at that time of $206,000, and distributing the same in accordance with the agreements to the four people interested therein." (Tr. 127)

Appellee has attempted to explain away a portion of the other evidence that the completed contract method was adopted. To counter the evidence that certain costs were brought into the 1942 computation of income, though not technically accrued, Appellee points out that other costs incurred in 1943 were not related back to 1942 (Br. 26). Of course, the evidence was that the renegotiation data was submitted in January, 1943. Exhibit No. 16 (Tr. 80), Exhibit No. 17 (Tr. 83). Since the books were also closed out in January, it is obvious that the entries to which Appellee now refers were made after the books were closed out (Tr. 231). Moreover, on the completed contract method of accounting, costs which are clearly not incurred until the year after completion must be deferred, despite the fact that, by so doing, "the purpose of the completed contract method, namely, to account for the entire results of a contract at one time, is defeated." *National Contracting Co. v. Comm'r,* 37 B.T.A. 689, 702, aff'd (8th Cir.) 105 F.(2d) 488. This evidence is thus wholly consistent with the completed contract method of accounting.

In reply to the testimony of the accountant who closed the books and prepared the return that the completed contract method was used (Tr. 217, 239), Appellee states that the Court found that his testimony was not credible (Br. 27). Of course, the only testimony of the accountant which the Court doubted was that the accountant believed that the contract was completed (Tr. 106). Although this conclusion of the District Court is not relevant to the issues

in this appeal, we do point out that there was only a slight amount of work which was still necessary to be done at the end of 1942 (Tr. 149, 231). And for accounting purposes (as distinct from tax purposes) a contract may be reported as completed "if remaining costs are not significant in amount". (Accounting Research Bulletin No. 45, Para. 9, Appendix page 3, *infra*). It seems evident, therefore, that the accountant was not testifying that he thought the contract had been accepted, but only that it was completed in the sense that for accounting purposes it was not inappropriate to treat the contract as completed (Tr. 219, 231). In any event, if Appellee had any basis upon which to dispute that the books were kept on the completed contract method, the evidence should have been submitted at the trial. The record shows that Appellee had present in court an expert witness who had examined the taxpayers' books (Tr. 244). The implication from Appellee's failure to have this witness testify is that no contrary evidence could have been adduced.

Let us now look to what is relied upon by Appellee to sustain the finding that the *accrual* method of accounting was adopted. That finding was also essential to the Court's decision below (Op. Br. 18-19). The whole of the evidence cited by Appellee in support of the lower Court's finding is based on two "X" marks and one letter from Mr. Daley to Mr. Radtke (Br. 21-23). The "X" mark on the renegotiation form has already been discussed (Op. Br. 14-16). It might additionally be noted, however, that this form was prepared two months before the tax return was required to be filed (Tr. 80). It thus is no evidence as to how the return was later prepared. Appellee has relegated the "X" mark on the tax return to a footnote (Br. 23) in which the Supreme Court case of *Aluminum Castings Co. v. Routzahn* (1930), 282 U.S. 92, is distinguished on the ground that there the taxpayer asserted that its declaration on its tax return should control. But Appellee has overlooked *Denman v. Squire* (6th Cir., 1940), 111 F.2d 921,

holding that the rule of the *Aluminum Castings Co.* case is also applicable when, as here, the government asserts that the declaration on the tax return should control.

The letter from Mr. Daley to Mr. Radtke which is relied upon by Appellee to show that profits were computed on the accrual basis in fact shows just the opposite. The fact that Mr. Radtke's share from the joint ventures was computed to two decimal places means nothing. The 1942 tax return also showed profits computed to two decimal places, though profits were only estimated. But of great significance is the first sentence of the second paragraph of this letter (Tr. 140). This reads as follows:

> "Our business arrangement has been a joint adventure, *and we are figuring it as though we were winding it up on this date.*" (Italics added.)

This letter is dated December 31, 1942. It is clear contemporaneous evidence that for accounting purposes the parties treated the Delta contract as if it were completed on that date.

The foregoing is the only evidence which is cited to support a finding of fact (if it had been made) that the taxpayers had elected the accrual method of accounting. No effort is made by Appellee to show from the evidence relating to the books of account that the accrual method of accounting was adopted for the purpose of reporting income, despite the fact that the cases hold that this is where that evidence *must* be found, if it exists. *Aluminum Castings Co. v. Routzahn,* 282 U.S. 92; *Niles Bement Pond Co. v. United States,* 281 U.S. 357.

The opinion and findings of the Court below also show no evidence from which it could be concluded that the accrual method of accounting was adopted. In the Court's opinion (Tr. 106) the following reasoning is disclosed:

> "It is clear that all of the income from the Delta contract was intentionally reported as accruing during the year 1942, and that the accrual method of accounting for such income was thereby adopted. It is not inappropriate to comment that the

taxpayers' financial status at the close of 1943 made it advantageous ex post facto to report the Delta income in 1943. It does appear that some of the Delta contract income in fact did not accrue until 1943 and was improperly included in the 1942 return. To this extent the 1942 return was erroneous."

While it seems somewhat startling, it appears from the first sentence that the Court reasoned that because the taxpayers included income which had *not* accrued, they thereby adopted the accrual method of accounting! See also Findings of Fact VII (Tr. 110). Perhaps the second sentence is somewhat more significant in seeking out the basic reason why the trial judge found for the Defendant. (See also the comment of the trial judge at the close of the trial, commencing at the bottom of page 247 of the Record.) It is, of course, a truism to say that refund claims are filed only when it is advantageous to the taxpayer to do so. The cases are numerous which hold that if a taxpayer has made an accounting error resulting in an overpayment of tax, he is entitled to a refund. See our Opening Brief, pp. 21-28.

It is respectfully submitted that the whole of the evidence reveals that the sum and substance of what the District Court did was to avoid following the decision of this Court in *E. E. Black Ltd. v. Alsup, supra* by characterizing the completed contract method of accounting as the "accrual method."

2. Even if the Books of Account Were Not Kept on the Completed Contract Method, Appellants Are Entitled to a Refund on That Basis.

Appellants have argued that even if the accounting method employed was not the completed contract method, they nevertheless are entitled to a refund computed by determining the income of the taxpayers for 1942 and 1943 by use of the completed contract method (Op. Br. 21-30). This is for the reason that the completed contract method is the only method which would "clearly reflect the income" from the Delta contract.

Appellee says that taxpayers argument in this respect "improperly assumes that the method employed by them in the original Delta War Venture return for 1942 reports income that was not earned" (Br. 29). It appears that this statement may be intended to present just one last time the unsupportable position that the original Delta War Venture return for 1942 was not erroneous. This is the position which the Internal Revenue Service and the Attorney General have maintained at all stages of this dispute up to and including their brief in the trial court. For example, in the original Revenue Agent's report on the claims for refund, dated January 30, 1951, the following conclusion is reached:

> "the contractor, on an accrual basis, would be required to accrue income on the contract in accordance with the percentage completed."

In a letter dated July 26, 1951 from the Conferee Revenue Agent to the taxpayers' representative after a hearing within the Internal Revenue Service, the following conclusion is stated:

> "On the accrual basis it appears that substantially all of the income from the contract in question was earned in 1942."

In a letter dated January 17, 1952 from the Chief, Appellate Staff of the Internal Revenue Service, informing Appellants that the refund claims would be disallowed, the following is stated as the basis for the proposed action:

> "the percentage of completion was practically one hundred per cent by the end of 1942, hence the profit was earned in 1942."[2a]

2a. It should be noted that in effect this is a concession that the completed contract method was used by the taxpayers. At the time this was written *E. E. Black Ltd. v. Alsup (supra)* had not been decided by this Court. Neither had the case of *Dally v. Comm'r* (1953), 20 T.C. 894, nor *U.S. v. Harmon* (1953), 205 F.2d 919. Accordingly, the law appeared to be that on the completed contract method of accounting substantial completion was all that was required. *Ehret-Day v. Comm'r* (1943), 2 T.C. 25.

This point of view was, of course, rejected by the Court below (Tr. 106), and Appellee elsewhere in its brief (Br. 11, 12, 13, 26, 29, 31) has conceded the point. See *Dally v. Comm'r* (1953), 20 T.C. 894, affirmed, 227 F.2d 724, certiori denied, 351 U.S. 908; *U. S. v. Harmon* (10th Cir., 1953), 205 F.2d 919; *L. O. Layton v. Comm'r* (1952), 11 T.C.M. 1115. See also the cases cited on page 19 of our opening brief. Appellee has not attempted to challenge or distinguish these cases from which it can only be concluded that the 1942 returns erroneously reported $472,722.15 of income from the Delta contract.

If the District Court was correct that, despite the erroneous inclusion of $472,722.15, taxpayers nevertheless reported their 1942 income on the accrual method of accounting, then the District Court should have examined whether that method, correctly applied, would "clearly reflect the income." Internal Revenue Code Sec. 41. Appellants have shown that the accrual method correctly applied would result in a very large loss for 1942 and an even larger profit for 1943. Thus the accrual method manifestly would not reflect the income earned in those years (Op. Br. 24).[3]

Notwithstanding the ridiculous results which would follow from the use of strict accrual accounting in connection with the Delta contract, Appellee argues that it is nevertheless proper in this case. Appellee has stated that "in cases involving a *fixed-fee contract,* with periodic partial payments as work progresses, taxpayers may elect either method; the accrual system, if properly applied, will clearly reflect the taxpayer's income." (Italics added.) (Br. 29) For this proposition, Appellee cites I.T. 3459 and the *Dally* case.

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3. In a footnote (Br. 26), Appellee has challenged the sufficiency of Exhibit 15 to the Stipulation of Facts (Tr. 79) to prove the amount of the erroneous inclusion in 1942. Appellee stipulated to this summary after being supplied with all of the Contracting Officer's estimates and certificates of approval. Moreover, both Appellants and Appellee relied upon this Exhibit in their briefs below, and the District Court found the improper accrual on the basis of this Exhibit. Accordingly, Appellee's point is without merit.

The Appellee has failed to note, however, that the Delta contract was *not* a fixed-fee contract. It was a *lump-sum* contract (Tr. 25, 26). The distinction for accounting and tax purposes between fixed-fee contracts, in which the contractor gets a fixed fee for his profit regardless of costs, and lump-sum contracts, in which the contractor in effect sells the completed product for a set price, is well recognized in both the accounting[4] and legal authorities.[5] If the contractor under a fixed-fee contract is entitled to 50%, 75% or 99% of his fee, certainly the portion of the fee which has accrued will reflect his income. This is the type of contract to which I.T. 3459, which is found in the Appendix to Appellee's Brief, relates.

The *Dally* case, on the other hand, involved neither a fixed-fee, nor a lump-sum contract. That case involved a "unit price" contract. The contract there called for the manufacture and delivery of 1,000 pre-fabricated housing units *at a specified price per unit.* 20 T.C. 894 at 895. A unit price contract for 1,000 units is little more than 1000 separate contracts, the profit from each of which can be determined as the unit is delivered.[6] It should be noted,

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4. See Accounting Research Bulletin Number 45: Long-Term Construction-type Contracts (Appendix, *infra*). Paragraph 1 of that Bulletin states that it does not deal with "cost-plus-fixed-fee contracts" or for products "billed as shipped" (unit-price contracts). The Bulletin is thus restricted to "lump-sum" construction contracts of the Delta type. As to fixed fee construction contracts see Accounting Research Bulletin Number 43, Chapter 11, Sec. A. See also "Construction-Type Contracts," The Journal of Accountancy, December, 1955 (p. 53).

5. See Herwitz "Accounting for Long-Term Construction Contracts: A Lawyer's Approach" 70 Harvard Law Review 449 (January, 1957). See also *H. S. Bent v. Comm'r* (9th Cir., 1932), 56 F.2d 99 at 102, quoted in footnote 6, immediately below.

6. This Court recognized that the accrual basis may be appropriate to unit price contracts and fixed-fee contracts but not to lump-sum contracts in *H. S. Bent v. Comm'r* (9th Cir., 1932), 56 F.2d 99 at 102, where the Court said:

> "[T]here is a more definite basis of ascertaining the amount of profit earned in the case of unit price contracts or income upon a contract on the basis of cost plus a fixed fee than there is on a lump sum contract where payments reflect only a portion of the amount earned."

moreover, that no issue was raised in the *Dally* case as to whether the accrual method clearly reflected the income from that contract.

As a matter of fact, the Treasury Department's own ruling (I.T. 3459) which is relied upon by Appellee, supports the position that the accrual basis will *not* clearly reflect income from a lump sum contract.

This Ruling (Appendix to Brief for Appellee) starts off by saying that the taxpayer regularly reports its income from construction contracts on the completed contract basis, but that it believes that method would not be satisfactory for the "particular Government contract here under consideration." The ruling then sets forth, in clear and unmistakable language, that the contractor is to receive "a specified fixed fee *for its profit*" and the ruling concludes that "*upon consideration of the terms of the contract* in question, the Bureau is of the opinion that the income from the contract accrues in the taxable years in which * * * the right of the taxpayer to payment therefor is fixed." And then, at the very end of the ruling is the significant notation that the ruling does not affect the taxpayer's practice of reporting income from other types of construction contracts on the completed contract method.

On the basis of any fair reading of this ruling, it is clearly applicable only where the contractor is entitled to a fixed fee for his profit, and is expressly made *in*applicable to other types of construction contracts. Moreover, the ruling states that in the case of fixed-fee contracts only, the Bureau is of the opinion that "the income accrues" when the "right of the taxpayer to payment therefor is fixed." The clear implication is that the Bureau believes that income from a contract of the Delta type should not be regarded as accruing before the contract is completed.[7]

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7. An excellent exposition of this position is found in Herwitz, "Accounting for Long-Term Construction Contracts: A Lawyer's Approach," 70 Harvard Law Review 449 (January, 1957), at 455-458.

Further support that the strict application of the accrual system to construction contracts will not be regarded as capable of "clearly reflecting the income" is the Government's own Regulation relating to the completed contract method. This Regulation is quoted beginning on page v of the Appendix to Appellee's Brief. It starts out by saying:

> "Income from long-term contracts is taxable for the period in which the income is *determined* [not "accrued"], such determination depending upon the nature and terms of the particular contract." (Italics and bracketed words added.)

The Regulation then goes on to say that persons whose income is derived from such contracts may prepare their returns upon "either" the percentage of completion or the completed contract method. There is no indication that the Treasury Department considers that a strict application of the accrual system is ever a proper way to "determine" the income from a contract of this type.[8]

By citing only the *Dally* case (in which a "unit price" contract was involved and in which the issue wasn't raised anyhow) and I.T. 3459 (which involves a fixed-fee contract) the Appellee reveals a basic fault in this part of its argument. The truth appears to be that there is no case holding that a strict accrual method is permissible in connection with a lump-sum construction contract, and there is substantial authority to the contrary.[9]

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8. See also Accounting Research Bulletin No. 45, paragraph 2 (Appendix, *infra*): "2. Considerations other than those acceptable as a basis for the recognition of income frequently enter into the determination of the timing and amounts of billings on construction-type contracts. For this reason, income to be recognized on such contracts at the various stages of performance ordinarily *should not be measured by interim billings*" [the accrual method]. (Italics added.) Compare this with paragraph 2 of the Bulletin on Fixed-Fee contracts (ARB 43, Chapt. 11A): "The fees may also be accrued as they are billable * * *"

9. In addition to the authorities cited in footnotes 4-8 and in the text, see also "Construction-Type Contracts," by the Research Department,

Despite these persuasive authorities, Appellants' case does not depend on the argument that the strict accrual method may never be used to report income from a lump sum construction contract, or that the completed contract method is really only the accrual method as applied to lump sum contracts. On pages 24-27 of their Opening Brief, Appellants have cited and fully discussed a total of 8 different cases holding that what might generally be an acceptable accounting method will be unacceptable if it does not clearly reflect income *in a particular case.* Appellants have also clearly set forth the misleading results which would follow from a strict application of the accrual method in this particular case. The Appellee has stated only that the cases discussed by Appellants "are distinguishable from this case, either on their facts or the issues involved" (Br. 29). The only case cited by Appellee is the *Security Flour Mills Co.* case (Br. 31). In that case the taxpayer attempted to deduct a single item of contested taxes in a year *prior* to the year in which liability had been established, and thus *before* the deduction accrued. The Court properly held that there was nothing in the statute which authorized a deduction prior to the time liability therefor was incurred. While that case is further au-

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American Institute of Accountants, Journal of Accountancy, December, 1955 at page 53:

> "This discussion will be confined to the type of contract where the contractor does not work on a fee basis, but rather agrees to a contract price which may give him either a gain or a loss upon the completion of the contract. * * *
>
> "It is sometimes suggested that the billings which have been made to a customer constitute a possible basis for the recognition of realized income on a partially completed contract. In some cases the customer permits early interim billings which are excessive in relation to the work performed, in order to provide working capital for the contractor. In other cases, interim billings may be kept below the costs incurred in order to protect the owner, although this is generally accomplished by retainage rather than deferment of billings. *Billings, therefore, except by coincidence, are not a suitable basis for profit allocation.*" (Italics added.)

thority that the original 1942 Delta Venture return was erroneous, it is not authority that the completed contract method should not be used when that is the only method which clearly reflects the income.

It follows, accordingly, that since the accrual method would not clearly reflect income from the Delta contract, Appellants are entitled to correct the errors in the 1942 return by correctly applying the completed contract method.

3. If the Delta War Venture Adopted the Accrual Method, It Is Entitled to Apply That Method Correctly.

In the previous pages of this brief, Appellants have set forth the reasons why the original 1942 Delta Venture return should have shown no receipts and no deductions. The Court below, however, apparently found that the 1942 return was erroneous "only" to the extent of $472,722.15. Despite the fact that Appellants proved at least this portion of the full error claimed,[10] the Court below held that Appellants could not recover. If this is the law, then it certainly is not good or just law.

But even apart from the basic injustice of the Court's decision below, Appellants have shown in their Opening Brief that they have complied with the most technical and stringent interpretation of the requirement that the claim for refund set forth the grounds upon which the refund is claimed.

Appellants noted in detail (Op. Br. 32-34) that the amended returns filed with the refund claims reduced the gross receipts reported as having accrued for 1942 by the amount of $472,722.15,

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10. Note again the authority that the completed contract method is only a specific application of the accrual method of accounting. See Footnote 7, *supra,* page 13 and the authorities cited therein. Appellants attempted to prove that all of the receipts should not have been accrued, but succeeded only in convincing the Court that a portion of the receipts should not have been accrued. Accordingly, the error proved was embraced within the larger error claimed.

and claimed that such receipts were advances only. This is clearly a claim that the original return was in error to the extent of $472,722.15, as well as to the extent of the full amount. Appellee has not addressed its brief to the point made by Appellants. Instead, Appellee (bottom pg. 35, top pg. 36) has, in effect, stated that by asserting the right to correct the error by use of the completed contract method, Appellants have somehow waived the right to correct the error by any other method.

Appellee sets forth on page 34 and elsewhere in its brief the position that the claims for refund "were based upon the premise that taxpayers had elected to report the income of the Delta War Venture on the completed contract basis." Appellee does not explain how it can take this position after its own counsel at the trial analyzed the language of the claims and told the Court that the essence of the claims was that the Appellants "made a mistake in filing them [the returns] on the accrual basis" (Tr. 136).

Appellee has not disputed that on the administrative level taxpayers took the alternative position that if they adopted the accrual method then there was still a substantial over-accrual of income. See Op. Br. 37. Appellee has also conceded in its brief that such administrative consideration is all that is necessary.[11] And as Appellants have previously demonstrated (page 10, *supra*), the Bureau of Internal Revenue was given the opportunity *on three different levels* to adjust this matter by recognizing the taxpayers' claim that even on the accrual method an error had been made, but on each of the three administrative levels the taxpayers' just and meritorious position was erroneously rejected.

Appellee has stated that Appellants did not raise the question of whether income was improperly reported on the accrual method

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11. Br. 32: "It is well settled that a taxpayer who brings suit after a claim for refund has been denied can rely for recovery only on grounds presented to *or considered by* the Commissioner." See cases cited at bottom of page 37 of Appellants' Opening Brief.

thority that the original 1942 Delta Venture return was erroneous, it is not authority that the completed contract method should not be used when that is the only method which clearly reflects the income.

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3. If the Delta War Venture Adopted the Accrual Method, It Is Entitled to Apply That Method Correctly.

In the previous pages of this brief, Appellants have set forth the reasons why the original 1942 Delta Venture return should have shown no receipts and no deductions. The Court below, however, apparently found that the 1942 return was erroneous "only" to the extent of $472,722.15. Despite the fact that Appellants proved at least this portion of the full error claimed,[10] the Court below held that Appellants could not recover. If this is the law, then it certainly is not good or just law.

But even apart from the basic injustice of the Court's decision below, Appellants have shown in their Opening Brief that they have complied with the most technical and stringent interpretation of the requirement that the claim for refund set forth the grounds upon which the refund is claimed.

Appellants noted in detail (Op. Br. 32-34) that the amended returns filed with the refund claims reduced the gross receipts reported as having accrued for 1942 by the amount of $472,722.15,

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10. Note again the authority that the completed contract method is only a specific application of the accrual method of accounting. See Footnote 7, *supra,* page 13 and the authorities cited therein. Appellants attempted to prove that all of the receipts should not have been accrued, but succeeded only in convincing the Court that a portion of the receipts should not have been accrued. Accordingly, the error proved was embraced within the larger error claimed.

and claimed that such receipts were advances only. This is clearly a claim that the original return was in error to the extent of $472,722.15, as well as to the extent of the full amount. Appellee has not addressed its brief to the point made by Appellants. Instead, Appellee (bottom pg. 35, top pg. 36) has, in effect, stated that by asserting the right to correct the error by use of the completed contract method, Appellants have somehow waived the right to correct the error by any other method.

Appellee sets forth on page 34 and elsewhere in its brief the position that the claims for refund "were based upon the premise that taxpayers had elected to report the income of the Delta War Venture on the completed contract basis." Appellee does not explain how it can take this position after its own counsel at the trial analyzed the language of the claims and told the Court that the essence of the claims was that the Appellants "made a mistake in filing them [the returns] on the accrual basis" (Tr. 136).

Appellee has not disputed that on the administrative level taxpayers took the alternative position that if they adopted the accrual method then there was still a substantial over-accrual of income. See Op. Br. 37. Appellee has also conceded in its brief that such administrative consideration is all that is necessary.[11] And as Appellants have previously demonstrated (page 10, *supra*), the Bureau of Internal Revenue was given the opportunity *on three different levels* to adjust this matter by recognizing the taxpayers' claim that even on the accrual method an error had been made, but on each of the three administrative levels the taxpayers' just and meritorious position was erroneously rejected.

Appellee has stated that Appellants did not raise the question of whether income was improperly reported on the accrual method

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11. Br. 32: "It is well settled that a taxpayer who brings suit after a claim for refund has been denied can rely for recovery only on grounds presented to *or considered by* the Commissioner." See cases cited at bottom of page 37 of Appellants' Opening Brief.

at the trial (Br. 38). However, there was no need to present oral evidence that on the accrual method of accounting a very substantial error had been made. The evidence necessary to prove this was already in the stipulation of facts (Tr. 79). And as to the claim that in Appellants District Court brief it was argued only that all receipts were erroneously included as a result of a mistaken application of the completed contract method (Br. 38), Appellee is being somewhat inconsistent. For on page 9 of Appellee's brief in the District Court, the following is found:

> "The taxpayers now contend in their brief filed here that the net income from this contract of $206,250.44, as shown on that return, *was erroneously computed under the accrual method.*" (Italics added.)

Immediately thereafter in its District Court brief Appellee conceded that this position was taken by the taxpayers "at the trial of this case."

As to whether Appellants can urge here that refunds should be granted on the basis of correctly applying the accrual method of accounting, two points may be made. In the first place, the doctrine that new "theories" (*grounds* for relief, not *amount* of relief) may not be urged for the first time on appeal is based upon considerations of orderly judicial procedure. If the Court below actually does consider a theory not urged, there is no reason why its decision with respect to that theory should not be subject to review on appeal. Secondly, the Court below in considering this question, was simply following the requirements of Rule 54(c) of the Federal Rules of Civil Procedure. Under this rule, District Courts are required to grant whatever relief the evidence reveals the parties to be entitled to.[12] The reason the relief which is now requested was denied below was not that Appellants had not there requested such relief, but because the Court found (erroneously)

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12. *Keiser v. Walsh* (1941), 118 F.2d 13; *Nester v. Western Union Teleg. Co.* (D.C. Cal, 1938), 25 F. Supp. 478.

that Appellants had not set forth as a *ground* for relief that some (but not all) of the Delta contract receipts were erroneously included in the 1942 return (Conclusion of Law III, Tr. 111).[13]

For ten frustrating years, the United States contended, contrary to the position maintained by taxpayers, that the 1942 return was correct. The taxpayers proved, and the District Court determined, that the return was erroneous. The United States now admits the error but contends, on the basis of highly procedural, technical and superficial arguments, that taxpayers should nevertheless be denied any refund. With respect to a somewhat similar but better founded effort on the part of the government, the Court of Appeals for the 10th Circuit said the following:

> "The question is not free from doubt, but on the whole, we are of the opinion that the sufficiency of the claim for refund was not put in issue, and that the plaintiff is entitled to recover this tax. The defendant concedes that he is entitled to it on the merits; and while 'men must turn square corners when they deal with the Government' [citing a case], the government ought to turn square corners when dealing with its citizens. There is another maxim applicable in both of these appeals, and that is that substance should be given the right of way over form. [Citing cases.]
>
> "The claim for refund should have been more particular; but if the defendant expected to avoid the repayment of this illegally collected tax on that account, he should have been more particular in his answer. The derelictions of the parties are about equal, and if the matter is at large, the tax ought to be repaid, for concededly the government has no right to it." (*Howbert v. Penrose,* 38 F.2d 577 at 581)

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13. Appellee's argument that the record does not provide sufficient information to compute the income on the accrual basis has no merit. See footnote 3, page 11, supra. Even if the record were insufficient, Appellee overlooks the Supplemental Stipulation between the parties (Tr. 101) and the provisions of Rule 28 of this Court. See also *Underwood v. Comm'r* (4th Cir., 1932), 56 F.2d 67; *Comm'r v. Wells* (6th Cir., 1942) 132 F.2d 405.

CONCLUSION

The decision of the District Court was erroneous. The judgment should be reversed and the case remanded.

Respectfully submitted,

ERIC SUTCLIFFE
WILLIAM D. MCKEE
ORRICK, DAHLQUIST, HERRINGTON & SUTCLIFFE
Attorneys for Appellants

January 15, 1956

(Appendix Follows)

Appendix

Accounting Research Bulletin Number 45: Long-Term Construction-type Contracts

Issued by the Committee on Accounting Procedure of the American Institute of Accountants

1. This bulletin is directed to the accounting problems in relation to construction-type contracts in the case of commercial organizations engaged wholly or partly in the contracting business. It does not deal with cost-plus-fixed-fee contracts, which are discussed in Chapter 11, Section A, of Accounting Research Bulletin No. 43 *(Restatement and Revision of Accounting Research Bulletins,* American Institute of Accountants, 1953), other types of cost-plus-fee contracts, or contracts such as those for products or services customarily billed as shipped or rendered. In general the type of contract here under consideration is for construction of a specific project. While such contracts are generally carried on at the job site, the bulletin would also be applicable in appropriate cases to the manufacturing or building of special items on a contract basis in a contractor's own plant. The problems in accounting for construction-type contracts arise particularly in connection with long-term contracts as compared with those requiring relatively short periods for completion.

2. Considerations other than those acceptable as a basis for the recognition of income frequently enter into the determination of the timing and amounts of interim billings on construction-type contracts. For this reason, income to be recognized on such contracts at the various stages of performance ordinarily should not be measured by interim billings.

GENERALLY ACCEPTED METHODS

3. Two accounting methods commonly followed by contractors are the percentage-of-completion method and the completed-contract method.

Percentage-of-completion Method.

4. The percentage-of-completion method recognizes income as work on a contract progresses. The committee recommends that the recognized income be that percentage of estimated total income, either:

(a) that incurred costs to date bear to estimated total cost after giving effect to estimates of costs to complete based upon most recent information, or

(b) that may be indicated by such other measure of progress toward completion as may be appropriate having due regard to work performed.

Costs as here used might exclude, especially during the early stages of a contract, all or a portion of the cost of such items as materials and subcontracts if it appears that such exclusion would result in a more meaningful periodic allocation of income.

5. Under this method current assets may include costs and recognized income not yet billed, with respect to certain contracts; and liabilities, in most cases current liabilities, may include billings in excess of costs and recognized income with respect to other contracts.

6. When the current estimate of total contract costs indicates a loss, in most circumstances provision should be made for the loss on the entire contract. If there is a close relationship between profitable and unprofitable contracts, such as in the case of contracts which are parts of the same project, the group may be treated as a unit in determining the necessity for a provision for loss.

7. The principal advantages of the percentage-of-completion method are periodic recognition of income currently rather than irregularly as contracts are completed, and the reflection of the status of the uncompleted contracts provided through the current estimates of costs to complete or of progress toward completion.

8. The principal disadvantage of the percentage-of-completion method is that it is necessarily dependent upon estimates of ulti-

mate costs and consequently of currently accruing income, which are subject to the uncertainties frequently inherent in long-term contracts.

Completed-contract Method.

9. The completed-contract method recognizes income only when the contract is completed, or substantially so. Accordingly, costs of contracts in process and current billings are accumulated but there are no interim charges or credits to income other than provisions for losses. A contract may be regarded as substantially completed if remaining costs are not significant in amount.

10. When the completed-contract method is used, it may be appropriate to allocate general and administrative expenses to contract costs rather than to periodic income. This may result in a better matching of costs and revenues than would result from treating such expenses as periodic costs, particularly in years when no contracts were completed. It is not so important, however, when the contractor is engaged in numerous projects and in such circumstances it may be preferable to charge those expenses as incurred to periodic income. In any case there should be no excessive deferring of overhead costs, such as might occur if total overhead were assigned to abnormally few or abnormally small contracts in process.

11. Although the completed-contract method does not permit the recording of any income prior to competion, provision should be made for expected losses in accordance with the well established practice of making provision for foreseeable losses. If there is a close relationship between profitable and unprofitable contracts, such as in the case of contracts which are parts of the same project, the group may be treated as a unit in determining the necessity for a provision for losses.

12. When the completed-contract method is used, an excess of accumulated costs over related billings should be shown in the

balance sheet as a current asset, and an excess of accumulated billings over related costs should be shown among the liabilties, in most cases as a current liability. If costs exceed billings on some contracts, and billings exceed costs on others, the contracts should ordinarily be segregated so that the figures on the asset side include only those contracts on which costs exceed billings, and those on the liability side include only those on which billings exceed costs. It is suggested that the asset item be described as "costs of uncompleted contracts in excess of related billings" rather than as "inventory" or "work in process," and that the item on the liability side be described as "billings on uncompleted contracts in excess of related costs."

13. The principal advantage of the completed-contract method is that it is based on results as finally determined, rather than on estimates for unperformed work which may involve unforeseen costs and possible losses.

14. The principal disadvantage of the completed-contract method is that it does not reflect current performance when the period of any contract extends into more than one accounting period and under such circumstances it may result in irregular recognition of income.

Selection of Method.

15. The committee believes that in general when estimates of costs to complete and extent of progress toward completion of long-term contracts are reasonably dependable, the percentage-of-completion method is preferable. When lack of dependable estimates or inherent hazards cause forecasts to be doubtful, the completed-contract method is preferable. Disclosure of the method followed should be made.

COMMITMENTS

16. In special cases disclosures of extraordinary commitments may be required, but generally commitments to complete contracts in process are in the ordinary course of a contractor's business and are not required to be disclosed in a statement of financial position. They partake of the nature of a contractor's business, and generally do not represent a prospective drain on his cash resources since they will be financed by current billings.

The statement entitled "Long-term Construction-type Contracts" was adopted unanimously by the twenty-one members of the committee, of whom two, Mr. Coleman and Mr. Dixon, assented with qualification.

Mr. Coleman and Mr. Dixon do not approve the statements in paragraphs 6 and 11 as to provisions for expected losses on contracts. They believe that such provisions should be made in the form of footnote disclosure or as a reservation of retained earnings, rather than by a charge against the revenues of the current period.

Mr. Coleman also questions the usefulness of the refinement of segregating the offset costs and billings by character of excess as set forth in the second sentence of paragraph 12. He suggests that a more useful alternative would be to show in any event total costs and total billings on all uncompleted contracts (a) with the excess shown either as a current asset or a current liability, and (b) with a supporting schedule indicating individual contract costs, billings, and explanatory comment.

NOTES

(See Introduction to Accounting Research Bulletin No. 43.)

1. Accounting Research Bulletins represent the considered opinion of at least two-thirds of the members of the committee on accounting procedure, reached on a formal vote after examination of the subject matter by the committee and the research department. Except in cases in which formal adoption by the Institute

membership has been asked and secured, the authority of the bulletins rests upon the general acceptability of opinions so reached.

2. Opinions of the committee are not intended to be retroactive unless they contain a statement of such intention. They should not be considered applicable to the accounting for transactions arising prior to the publication of the opinions. However, the committee does not wish to discourage the revision of past accounts in an individual case if the accountant thinks it desirable in the circumstances. Opinions of the committee should be considered as applicable only to items which are material and significant in the relative circumstances.

3. It is recognized also that any general rules may be subject to exception; it is felt, however, that the burden of justifying departure from accepted procedures must be assumed by those who adopt other treatment. Except where there is a specific statement of a different intent by the committee, its opinions and recommendations are directed primarily to business enterprises organized for profit.

AIA Committee on Accounting Procedure (1954-1955).